



TUC evidence to the
Independent Public
Service Pensions
Commission no. 2

Submission in response to the final call for
evidence

Executive Summary

Introduction

The TUC supports the Commission's objective of establishing a sustainable and affordable future for public service pensions that provides both adequacy and fairness.

Unfortunately, it is far from clear that it will be possible to achieve the objectives the Commission has identified at the same time as members are facing a significant and arbitrary increase in their contributions and a material reduction in the expected value of their benefits arising from the switch in indexation from the retail prices index (RPI) to the Consumer Price Index (CPI). The Commission's work cannot be separated from the environment in which it is being undertaken and we urge that this should be recognised in the Commission's final report.

The need for a coherent approach

The TUC urges the Commission to take the opportunity to recommend a coherent approach to any reform of public service pensions, rather than the disjointed array of Government initiatives currently faced by public service workers. In particular we urge the Commission to recognise the crucial role that the existing arrangements, specifically cap and share, should have in determining future public service pensions.

Scheme design

The TUC believes that scheme design is a matter for negotiation, so that it can best reflect the respective needs and objectives of the employer and the employees. We therefore strongly reject any suggestion that there can be a single "one size fits all" approach to benefit design, in either the public or private sectors.

We also wish to highlight the significance of the key parameters for a career average revalued earnings (CARE) scheme, which are the accrual rate and the index used to revalue earnings when calculating the average. They are essential factors that need to be taken into account when judging the relative merits of a CARE scheme.

Risk-sharing

The TUC believes that the existing cap and share framework provides the right mechanism for sharing the risks inherent in providing such schemes between members and employers and ultimately the taxpayer. In particular, the flexibility that can be achieved through a system based on negotiations offers a more robust approach to risk sharing than a mechanistic approach based around specific factors such as mortality. The experience of the last decade demonstrates that cap and share is a practical approach.

Adequacy

Adequacy has to be judged relative to the standard of living achieved over the individual's working life and be sufficient to enable that individual to maintain that standard of living through their retirement.

Employee understanding and choice

The TUC believes that benefits are less valuable to both scheme members and their employers if they are less comprehensible. There is currently a good understanding in the public service of the value of the existing schemes but the continuation of this understanding cannot be taken for granted. It requires a consistent programme of communication with current and prospective members of these schemes and stability in the form of pension provision.

Pensions and plurality of provision of public services

The retention of the Fair Deal protections is essential to prevent a race to the bottom in terms of pension provision in outsourced public services. Measures such as the expansion of Admitted Body Status (ABS) should be investigated with a view to widening access to public service schemes, with appropriate negotiations over the distribution of risks and costs of past service.

Administration costs

Administration costs are generally much lower in the public service schemes, mainly on account of the natural advantage of their scale, but also as a result of sound management on the part of those responsible. The TUC believes that there

is some scope for the existing governance bodies for the various public service schemes to develop a greater role in this area.

Transition issues

The TUC believes that the issues that would arise from the transition to any new pension structure for public service workers are, at present, poorly understood, while being of crucial importance. This includes the direct cost of the process of change itself; the potential uncertainty and unpopularity of the changes; possible technical difficulties; and for the LGPS, questions about the impact on its funding.

In addition, members need to have confidence that their accrued rights will be fully protected, in line with commitments made by the coalition government.

Introduction

The TUC represents 58 affiliated trade unions with over six million members. We welcome the opportunity to submit evidence and views that will assist the Commission in completing its review of current pension provision for public service employees and the objectives that should guide such provision in future.

The TUC supports the Commission's objective of establishing a sustainable and affordable future for public service pensions that provides both adequacy and fairness. These objectives are incontestable but, for the reasons set out in this response, we believe that it will be extremely difficult to achieve any sustainable change in the current economic and political environment. The TUC recognises that circumstances can give rise to the need for change but we urge the Commission to recognise in its final report that the process that leads to such change should be based on detailed evidence; that it should be scheme-specific; and that it should follow a proper process of negotiation and agreement between the appropriate trade unions and the Government. The TUC's core message is that it is both possible and appropriate to establish sustainable and affordable public service pensions within the existing structures. The involvement of the trade union movement over the last ten years, during which significant change has been agreed, demonstrates this clearly.

The TUC welcomed a number of important points in the Commission's interim report. In particular the report recognised the importance of providing good quality pensions to public servants; rejected a race to the bottom in pension provision; and confirmed the long-standing argument of the trade union movement that these pensions are not 'gold plated'. It also made clear that claims that expenditure on public service pensions was out of control were incorrect, a point that has been re-emphasised by the recent National Audit Office report, *The impact of the 2007-08 changes to public service pensions* (National Audit Office, 2010). It is important that these points are reiterated in the Commission's final report, as they have

been ignored in much of the subsequent media and political discussion¹.

The first section of this response sets out the TUC's concern about the environment in which the Commission's work is being carried out, which we believe significantly reduces its capacity to establish a sustainable and affordable outcome. It is far from clear that it will be possible to achieve the objectives the Commission has identified at the same time as members are facing a significant and arbitrary increase in their contributions following the Spending Review, and a material reduction in the expected value of their benefits arising from the switch in indexation from the retail prices index (RPI) to the Consumer Price Index (CPI). At the same time, public service workers are facing pay cuts, an automatic two year pay freeze and significant threats to their future employment. The Commission's work cannot be separated from the environment in which it is being undertaken and we urge that this should be recognised in the Commission's final report. The Commission should also be mindful of the need for absolute clarity about the scope of recommendations and the interconnectedness of the various reforms and changes currently underway.

The later sections of the TUC's submission set out in turn our views on the main areas identified by the Commission for its final report. In making its comments the TUC's submission looks at issues of general concern to all public service schemes and to the majority that are on an unfunded basis. However, we recognise the unique character of the public service schemes that are funded, primarily the Local Government Pension Scheme (LGPS). The major local government unions Unison, Unite and GMB, who collectively represent 1.2 million current members of the LGPS, have developed a more detailed joint submission on the specific issues associated with that scheme. This is attached as an annex to the TUC response.

The concluding section summarises the approach to public service pension provision that the TUC would like to see in the Commission's final report.

¹ For example, one national newspaper headlined its story on the Interim report "Public sector should lose gold plated pensions ...", despite the Commission's conclusion in the report that "It is mistaken to talk about 'gold-plated' pensions as being the norm across the public sector".

The need for a coherent approach

The work of the Commission cannot be separated from the environment in which it is being undertaken. In particular, in the context of the arbitrary contribution increases announced in the Spending Review and the changes to indexation arrangements announced in June 2010, public service workers are understandably anxious about the work of the Commission and the way in which this interacts with Government policy. The TUC therefore urges the Commission to take the opportunity to recommend a coherent approach to any reform of public service pensions, rather than the disjointed array of Government initiatives now faced by public service workers. We also urge the Commission to recognise the crucial role that the existing arrangements, specifically cap and share, should have in determining future pensions in the public service.

There are three factors that give rise to major concerns on the part of public service employees, as follows:

- The arbitrary increase in contributions
- The change in pension indexation; and
- The failure to give due credit to the existing cap and share provisions.

Above all, the impact of the combination of these factors cannot be understated. They are discussed in turn below.

Factor one: The arbitrary increase in contributions

The TUC questioned the requirement in the Terms of Reference for the Commission to identify short-term savings. We do not accept the case for change that was put forward in the Commission's interim report and, in particular, we do not believe that there is any justification for an immediate and arbitrary increase in member contributions, particularly given the context of a pay freeze and job losses set out above. The Treasury has focussed on contribution rate increases despite the consequences for scheme participation rates, which will

have an impact on scheme sustainability far exceeding the assessment made in the Spending Review.

In terms of the respective shares of the cost of these schemes that is met by the employer and employees, there is no hard evidence of an imbalance, even when allowing for the increase in longevity that has occurred over the past 20 years. Both labour market theory and the practical experience of trade union negotiators leave no doubt that pay levels are affected in practice by both the level of member contributions and the increasing cost to employers of providing pensions. Members pay for their pensions not only directly, in the form of member contributions but also indirectly, through an impact on the level of their pay. This adjustment is occasionally explicit, for example in the armed forces, but more typically it is implicit. Either way, the impact on members' pay ought not to be disregarded.

The TUC is disappointed, therefore, at the lack of analysis of how different levels of employee contributions and the increasing cost of providing pensions have had an impact on the overall level of public service pay. This is compounded by uncertainty about the future discount rate that will be used to assess the current cost of providing pensions. This is crucially important as it means the Commission is unable to provide evidence of the extent of any imbalance between employer and employee contribution, or even that such an imbalance actually exists.

The increase in contributions announced in the Spending Review is not only unjustified by any hard evidence but it also places significant obstacles in the way of the Commission's work. The impact it will have on the total amount payable by members, even those on middle incomes, coupled with the cuts in benefits that are already in the pipeline, means that it will be impossible to achieve effective protection for low-paid workers while maximising take-up across the workforce and offering scope for the provision of adequate pensions. Evidence from individual unions relating to specific schemes will illustrate the point, but the general issue is that the increases in contributions imposed under the Spending Review are likely to be significantly higher than 3 per cent for large parts of the workforce because of the requirement to protect low-paid workers. This effect will be particularly marked in schemes such as the LGPS, which are characterised by a high proportion of low-paid members. When coupled with a reduction in members' benefits, there is a real danger that

large numbers of public service workers will be driven out of these schemes.

The pressure on members to opt out of these schemes or not to join in the first place will be significant. There will be many people who, whatever the advantages of belonging to a scheme, simply cannot afford the reduction in their take-home pay that will result from contributions that could double as a proportion of their pay. The costs of raising a family, buying a home and paying off student debts are bound to mean that large numbers feel they have little choice but to opt out of pension saving for just those parts of their working life that are crucially important in securing an adequate pension.

Driving employees out of pension provision in this way would, of course, be most short-sighted, given the coalition government's intention set out in the May 2010 Coalition Agreement, to "help reinvigorate occupational pensions" and to encourage "high-quality pensions" for all employees. The TUC therefore urges the Commission to make clear the importance of prioritising the highest possible level of participation in public service pension schemes. The failure to give adequate consideration to this issue has been a key factor in the low and diminishing participation rates in many private sector schemes.

Factor two: The change in pension indexation

The change in revaluation rate from RPI to CPI will, if implemented as the Government intends, have a major impact on the value of the benefits that members will accrue in the future. According to the Commission's own figures in its interim report, the change will reduce the value of the public service schemes to current members by around 15 per cent on average. This is in addition to the impact of the 2007-08 changes to public service pensions, which have been estimated by the National Audit Office to reduce costs in the longer term by a further 14 percent (National Audit Office, 2010). There will also be a material reduction in the cost of future pensions as a direct result of the forthcoming two year pay freeze. In the LGPS the scheme costs have already reduced faster than expected since the last valuation, and pay cuts and the indexation change are set to augment the significant cost reductions in train as a result of the introduction of the new scheme for all members in 2008.

While we recognise that the decision to change the revaluation rate was made by the Government, separately from the work of the Commission, it will have a significant impact on the baseline for the Commission's work.

The change in the index is also significant in the context of the review because of the damage it will cause to career average schemes and, in particular, to nuvos in the Civil Service and other existing CARE schemes in the public sector. This is a change that the Government intends to impose without negotiation or even, it appears, a proper understanding of the impact of such a change on a CARE arrangement. More detail is provided later in this response on the importance of the basis used for revaluing past earnings in a CARE arrangement, but, given the basis upon which nuvos was negotiated, the change represents a clear breach of faith on the part of the Government. It also, and of direct relevance to the work of the Commission, is bound to raise real concerns among scheme members about the security of their rights in CARE schemes more generally. The TUC would therefore encourage the Commission to make clear to the Government that employees will not accept any benefit structure which means accrued rights can be arbitrarily changed by the employer.

Factor three: The 2007 reforms and cap and share arrangements

The TUC is concerned that the interim report of the Commission and the call for evidence for the final report both appear to dismiss the efficacy of cap and share before it has been tested. All the available evidence is that the arrangements actually have been effective. This was corroborated by the recent National Audit Office report, *The impact of the 2007-08 changes to public service pensions* (National Audit Office, 2010). This included the following conclusion:

"14. By making changes in 2007-08 to pension schemes for civil servants, NHS staff and teachers, the Treasury and departments overseeing the schemes acted to tackle potential future growth in costs to taxpayers. As a result of the changes, which are on course to deliver substantial savings, long-term costs are projected to stabilise around their current levels as a proportion of GDP. The changes are also set to manage one of the most significant risks to those costs, by transferring from taxpayers to employees

additional costs arising if pensioners live longer than is currently projected."

The TUC was disappointed that the Commission's interim report did not consider how both the changes that flow from its work and the Government's initiatives should be handled within the cap and share arrangements. These provisions were agreed in 2007-08 for the three main unfunded public service schemes, i.e. the NHSPS, the PCSPS and the TPS and also provide a model for the other public service schemes, although the detail of how they should apply in these schemes has yet to be agreed. The TUC's response to the Commission's initial call for evidence explained how these provisions are sufficient to address the issues of cost and risk-sharing and provide a basis for sustainable long-term pension provision in the public service.

The established cap and share provisions provide the appropriate framework for considering the extent of any contribution adjustments and changes to benefits. Despite this, it is apparent that government departments are in fact pressing ahead with considering the impact and potential implementation of the contribution rate increases announced in the Spending Review in advance of and separately from both the cap and share provisions and whatever proposals flow from the Commission's final report. The level and pace of activity differs from scheme to scheme but there is also inconsistency about the relationship between the 3 per cent increase announced in the Spending Review and the potential increases under existing cap and share arrangements; and also about whether or not contribution increases are permanent, or are a temporary measure, pending the Commission's final report.

One feature of these discussions that the TUC believes should be of particular concern to the Commission, is that some departments appear to be taking the reference in the interim report to a 50/50 split of cost between the employers and the employees in one particular scheme in the distant past as a recommendation. The existence of such a split is arguable, as there were other pension costs that were not included in the formula, for example the cost of pension increases. In any event, we understand that the Commission has not and will not be recommending a 50/50 split and we would therefore welcome a clarification of this position in the Commission's final report.

Any changes to the public service pension schemes, including any increase in contributions, any alteration in the indexation arrangements and any change in the benefit

structure must be the subject of comprehensive negotiation with the relevant unions in each scheme under the established structures. It is wrong to separate decisions about contributions from those about benefits in the way that the Government has done, and it is unreasonable to increase contributions at a time when benefits are uncertain, whether because of the forthcoming valuations or the as-yet incomplete work of the Commission. If benefits are to be changed then it is axiomatic that any decisions about contribution rates should be re-visited. The only sensible approach is for the Government to assign a cost envelope for each scheme and then leave those with the best knowledge of the membership (both in terms of structure, needs and objectives) to identify and implement benefits in a partnership framework between employers, employees and their representatives, i.e. leave the details to those most directly affected.

Scheme Design (Question 1)

The principle that underlies the TUC's approach is that scheme design is a matter for negotiation, so that it can best reflect the respective needs and objectives of the employer and the employees. Whatever design is agreed through such negotiations, it is inevitable that in practice it will be chosen on the basis of relative advantages. We therefore strongly reject any suggestion that there can be a "one size fits all" approach to benefit design, in either the public or private sectors. For instance, it is vital that pension ages differ for schemes such as the Fire Service scheme where a high degree of physical fitness is a requirement, and that the different membership profiles of the schemes are taken into account. The Commission should recognise that each scheme has evolved over time to meet the specific needs of its own members.

The TUC is concerned, therefore, that the Commission, in its interim report and in subsequent discussions, has given the impression that it is giving favourable consideration to recommending a career average revalued earnings (CARE) approach in all circumstances and for all workgroups. This simplistic approach risks flying in the face of the experience that unions have had over many years in giving serious consideration to such arrangements. Trade unions have been and are prepared to consider a CARE scheme and,

in one notable example, the Civil Service, have supported its introduction. However, in other cases, for example the NHSPS and the TPS, the unions and the employers, went through the figures in great detail and decided ultimately to stick with final pay. In the NHSPS, any potential inequality between members is being dealt with through tiered contributions, while in the TPS both the employers and the unions decided that such adjustments were unnecessary as the majority of teachers have a relatively homogenous career path. The TUC believes it would be wrong for the Commission to substitute a theory about what constitutes a good benefit structure for the practical experience of members' representatives and employers.

Concern on the part of trade unions about CARE arrangements is not based on unthinking endorsement of the status quo or on a wish to favour one group of workers at the cost of another. We understand the arguments in favour of CARE schemes and recognise the advantages offered by such schemes, provided that the overall value is equivalent to the current arrangements. However, given that benefit design is a matter of balancing a number of different objectives, the Commission should recognise that final pay arrangements have a number of points in their favour that can be summarised as follows.

- First, workers will be well aware that the majority of changes to CARE arrangements have, in practice, led to members accruing worse benefits, even for the supposed beneficiaries of the CARE approach. The significant exception to this experience has been *nuvos*, where a clear cost envelope was adopted as part of the negotiations and then adhered to. But now even this example is now problematic, due to the change in the basis for the revaluation of earnings from the RPI to the CPI without any notice, let alone discussion.
- Secondly, a final pay arrangement can provide a meaningful basis for the replacement of income into retirement, whereas CARE schemes refer to an individual's income many years in the past that, even if revalued at a reasonable rate, might not be relevant to the income they seek in retirement. The benefits payable from a final pay scheme are also relatively transparent to members, giving them a good indication of how their benefits will increase, so long as they remain as active members and have relatively progressive career paths.

- Thirdly, although employers sometimes try to suggest that pensions are provided out of benevolence, their existence depends far more on the commercial necessity of attracting, retaining and, in due, course, enabling staff to leave. This means, to the extent that this is true, that there is an opportunity for negotiations to offer added value to longer-service employees, at no cost to others. Experience in the private sector suggests that a CARE scheme can become a lowest common denominator arrangement, with no added benefit to the supposed beneficiaries, but a significant loss to others.

What all this means is that the pursuit of fairness as an abstract objective without regard to practical considerations, can lead to the race to the bottom approach that is rightly criticised in the interim report. The TUC is concerned, therefore, about the view of the Commission, indicated in discussions, that the need for employers to have effective recruitment, retention and retirement policies should, as a matter of principle, be handled solely through pay. This is not how the process of agreeing terms and conditions of employment works in practice. The TUC believes, on the contrary, that these are all issues that should be dealt with through collective bargaining, so that the specifics are the workforce can be taken into account. In addition, decent pension arrangements play an important and widely-recognised role in recruiting and retaining a talented and motivated workforce in the public sector.

The Government has a number of objectives when deciding on what pension benefits it offers to its employees, i.e. to provide a package of pay and conditions, including basic pay, bonuses, pensions and holiday, which meet recruitment and retention requirements cost-effectively. But the government also:

- Has a responsibility, as part of its overall national pensions policy, to ensure its citizens have adequate pensions to avoid hardship in old age; and to limit demands on the taxpayer through means-tested benefits; and
- Has a role in providing public service pensions to set "the right example to private sector employers in terms of continuing to deliver a substantial share of remuneration in the form of 'deferred pay' as occupational pension benefits". (15 November 2005,

letter from the Chief Secretary to the Treasury to the Secretary of State for Health.)

The TUC also wishes to highlight the significance of the key parameters for a CARE scheme, which are the accrual rate and the index used to revalue earnings when calculating the average. These are essential factors that need to be taken into account when judging the relative merits of a CARE scheme and are discussed in turn below.

The Accrual Rate: The first point to make is that whatever the basis for revaluing earnings, the revalued average over the whole period of membership will almost always be lower than an individual's final pay. This means that the accrual rate needs to be higher in a CARE scheme than a final pay scheme to deliver the same level of pension. The extent of the difference that is necessary is well illustrated by nuvos, where the annual accrual rate is 2.3 per cent of revalued average earnings, as compared to 1.67 per cent in a final pay scheme of equivalent cost. In other words, the CARE accrual rate had to be 38 per cent greater than the equivalent final pay accrual rate. If allowance were now to be made for the impact of the subsequent switch to CPI as the basis for the revaluation of average earnings, the accrual rate would have to be more like 2.6 per cent, which is 56 per cent greater. The fact that many CARE schemes in the private sector are only offering an accrual rate of 1.67 per cent or less simply demonstrates the poor quality of such schemes. Even so, it is hard to convince people of the sort of accrual rate that is required and the TUC urges the Commission to make the point clear in its final report.

The Revaluation Rate: The poor quality of CARE schemes in the private sector is almost always compounded by what are manifestly inadequate bases for the revaluation of earnings. The value of a CARE scheme obviously depends on how average earnings are calculated and all too often the index used to bring past earnings up to date is capped at too low a rate. The whole idea of a CARE scheme is to express past earnings in up to date terms and if increases are capped, particularly at what is historically a low rate for pay increases of 2.5 per cent, the scheme will fail to deliver. It is self-evident, at least in principle, that the most appropriate index for revaluing past earnings to bring them up to date is an index of average earnings, or a close proxy such as the RPI plus a fixed percentage. This is why the index of national average earnings was chosen as the basis for revaluing past earnings for the purpose of

the State Earnings Related Pension Scheme and, subsequently, the Second State Pension. In practice, CARE schemes have tended to use the RPI, although this means that a higher accrual rate has to be used to deliver a scheme of equivalent value. This is effectively what happened with nuvos. The net result of using a higher accrual rate and a lower index is to give greater weight in the formula to earnings later in working life, which is not necessarily an unacceptable outcome.

The TUC notes that the Commission's call for evidence for its final report describes a number of other types of pension scheme in addition to career average schemes. However, these have to be seen in the context of the Commission's conclusion in its interim report that there is no need for any change in the existing funding arrangements for public service schemes (including the funded basis for the LGPS and the unfunded approach to the other major schemes). The TUC supports the conclusion that defined contribution (DC) should be ruled out as an option, and we would argue that this point applies equally to DC used as a top-up to a defined benefit scheme.

We also urge the Commission to reject any move to what is described as a Notional DC scheme. Such schemes are either established within clearly established parameters, in which case they are functionally indistinguishable from a DB scheme with equivalent parameters, or the parameters are uncertain, in which case members will find them unacceptable. It cannot be overstated that this is not a theoretical exercise. Too great a leap into the unknown would risk destroying public service workers' faith in the value of their pension provision.

The call for evidence also mentions the possibility of nursery schemes. The TUC understands the argument that such schemes have a role where the cost of being a member of the main scheme is high, which of course will be the case if the Government proceed with the proposed increase in member contributions. However, we are concerned about any arrangement that weakens the overall level of provision, and unless membership has a limited term, it has the potential to become an inferior default. Nursery schemes also have a bigger proportional impact on those with shorter working lives, such as some health professionals with lengthy training requirements.

Risk-sharing (Questions 2 to 9)

Given the Commission's conclusion that pension provision for public service workers, with the significant exception of the LGPS, should continue to be on an unfunded basis, the TUC believes that the existing cap and share framework provides the right mechanism for sharing the risks inherent in providing such schemes between members and employers and ultimately the taxpayer. In particular, the flexibility that can be achieved through a system based on negotiations offers a more robust mechanism for risk sharing than a mechanistic approach based around specific factors such as mortality. The Commission should recognise that overly prescriptive rules mean that schemes end up dealing with the last big problem and are unable to meet new challenges as they arise.

The experience of the last decade demonstrates that cap and share is a practical approach. Where they consider it appropriate, the relevant unions have been prepared to agree changes in benefits and increases in retirement age as ways of responding to rising pension costs because of factors like greater longevity. Unions have also been prepared to agree fundamental changes in benefit structures, for example in the Civil Service, with the agreement to a CARE arrangement for new entrants. Another example of negotiated change is the tiered contributions for different earnings bands in the NHSPS, which mitigate against the high-flier effect and the impact of longer life expectancies for the higher paid. Most importantly, unions have accepted the need for the Government to cap its pension costs, with members bearing the brunt of future developments through further negotiated increases in contributions or reductions in benefits.

The proven success of this approach, as noted in the recent NAO report, *The impact of the 2007-08 changes to public service pensions* (National Audit Office, 2010), contrasts with largely unknown outcome of switching to other forms of risk-sharing, such as the various forms of what are described as "hybrid schemes". These are effectively an unknown quantity, in terms of how far they would actually deliver the intended results and how they would be regarded by members. It is also clear that they would fail to meet the simplicity test, both at the time of transition and

subsequently. Finally, such schemes are almost always unacceptable to members because their prospective benefits are either woeful or they depend on parameters that are under the arbitrary control of the employer, because that is how employers with such schemes seek to control their level of risk. It is simply not possible to express a general view about the acceptability of a benefit structure without a very clear understanding of what parameters will apply and the cost envelope used.

We understand that the Commission is in the market for ideas but it is important to understand that this is not a green-field site, where it is possible to conduct a series of experiments to discover what might or might not work. It has to be right first time so, where there is an established system for controlling risk that has already demonstrated that it can deliver, i.e. the cap and share arrangements, it would be perverse to consider untried alternatives. This does not mean that the cap and share mechanism should not be subject to review in the light of how it works in practice, but this should be based on the experience of the current round of valuations and the subsequent series of negotiations.

Adequacy (Questions 10 to 13)

The TUC believes, like the Commission, that public service workers should be able to accrue an adequate pension over a normal working lifetime with a reasonable degree of certainty. For this purpose we do not consider that adequacy can be judged in absolute terms by reference to a flat-rate assessment, regardless of the previous income of the individual. Adequacy has to be judged relative to the standard of living achieved over the individual's working life and be sufficient to enable that individual to maintain that standard of living through their retirement.

It is to be hoped that this is what the Prime Minister had in mind when he stated in a televised public question and answer session, that, "We want to have good pensions in the public sector"². This must mean more than a bare minimum.

The call for evidence refers to the approach to adequacy set out by the Pensions Commission chaired by Lord Turner (Pensions Commission, 2004) and this is clearly based on a relative approach. However, the TUC cannot give a blanket endorsement to this approach. The main problem is that the Turner Commission's report is somewhat vague about what exactly is meant by the "replacement rate", as all it says in the glossary is that "This measures income in retirement as a proportion of income before retirement". So it fails to make clear what income before retirement it has in mind, i.e. it could be anything from that received immediately before retirement to that received over the entire working lifetime.

A second problem with the Pension Commission's benchmarks is that subsequent developments affecting the costs of later life risk rendering the Turner benchmarks out of date. Most notably, the increasing responsibility individuals have for funding their own social care has changed the cost of retirement since 2004.

A third problem with the benchmarks is that they are based on two assumptions about what income is required post-retirement. The first assumption is that pensioners need a net income after retirement that, at most, is only 80 per

² http://www.bbc.co.uk/blogs/nickrobinson/2010/06/cameron_and_cle.html
(2 July 2010)

cent of their net income before retirement, after allowing for changes in tax and National Insurance. The second assumption is that those people with an income higher than £25,000 in 2004 terms require an even lower proportion of their net income in retirement. For example, at an income of £50,000 per annum the assumption is that an adequate net replacement rate is less than 60 per cent. The TUC does not accept these assumptions and must therefore regard the Pension Commission's benchmarks as simply a step along the way towards an adequate level of retirement income.

The TUC also wishes to stress that adequacy involves the maintenance of a standard of living throughout retirement. We are most concerned, therefore, that the maintenance of living standards for public service pensioners has been harmed by the Government's declared intention to link of public service pensions to the Consumer Prices Index (CPI) from April 2011, since it is known that it is intrinsically lower on average than the RPI, simply because of the way it is calculated. It is worth emphasising, therefore, that the statistical profession has reservations on the use of CPI in its current form. In a letter of 6 October 2010, Sir Michael Scholar KCB, Chair of the UK Statistics Authority said, 'We believe that the CPI should become the primary measure of consumer price inflation but only when the inclusion in the index of owner occupiers' housing costs has been achieved'. The ONS will be consulting about possible changes to the index and it is nonsensical to give such prominence to an index that is such an unknown quantity.

There is one further aspect to adequacy that needs to be given attention. It requires a benefit structure that can cope with varied career patterns and not just those individuals who have the same employer for the whole of their working life. This means that the benefit formula should be set on the basis that there will some changes in employment or, in other words, short-service employees receive a reasonable deal, as well as those who work through to retirement. It should also protect those workers who have gaps in employment due to family responsibilities.

Employee understanding and choice (Questions 14 to 17)

The TUC believes that benefits are less valuable to both scheme members and their employers if they are less comprehensible. We therefore agree that one of the principles against which the structure of public service pensions should be judged is that schemes should be widely understood. By this we mean that members should have a general appreciation of the value of their benefits rather than a detailed knowledge of the scheme rules or how the scheme is managed. We believe that the available information shows that public service workers do have a good understanding of their schemes in this sense, reflecting a general perception of quality derived from their defined benefit basis. This is demonstrated primarily by the high level of membership across employment and age groups when it is available, particularly when compared to equivalent groups in the private sector. It is also shown by the willingness of members to take industrial action in defence of their pensions in the past.

The continuation of this level of understanding cannot be taken for granted. It requires, first, a consistent programme of communication with current and prospective members of these schemes. Secondly, it needs stability in the form of pension provision, as such understanding is not something that can be created overnight or even in two or three years. This, of course, is one of the reasons why the TUC is opposed to any precipitate change in the structure of public service pension provision, on top of the changes to the CPI and increased contributions. We have no doubt that it would do serious damage to employee understanding, leading to a lack of value to the employer and, potentially, a significant decline in membership which would ultimately lead to a greater call on state means-tested benefits.

We are less convinced that choice has a significant role in promoting a fair and sustainable pension system, if it means the opportunity to choose an inadequate pension, particularly where this can be a response to short term pressures. The need for an adequate benefit, related to income while at work along the lines indicated above, is effectively universal but is unlikely, in practice, to lead to any significant "over-provision" of pension. The real

risk of offering too much choice is that because of the pressures of a normal lifetime, i.e. gaps in a working life, the bunching of different financial pressures at certain points in that lifetime and the difficulty of making personal choices about financial needs in the longer term, large numbers of people will end up with inadequate benefits. This will not only be a problem for them, it will be at variance with government policies to promote better pension provision and will result in greater pressure on means tested benefits.

The conclusion to be drawn, therefore, is that there should be a single benefit structure for each bargaining unit with limited special provisions, such as a lower retirement age for groups such as the uniformed services where physical strength is a specific career requirement. It also needs to be emphasised that these public service schemes should be the arrangement used for the purposes of auto-enrolment, when the new provisions come into force. While the TUC strongly supports the introduction of NEST, the proposed arrangements including low contribution rates still fall short of providing what we regard as an adequate pension and it would be unacceptable for it to become, in effect, the default choice for public service workers.

Pensions and plurality of provision of public services (Qus 18 to19)

The Fair Deal provisions established in 2000 require the maintenance of comparable pension provision for workers who deliver outsourced public services. The Commission's interim report stated that these provisions make it more difficult for private and third sector organisations to provide public services. The specific issue of Fair Deal has been deferred to a Government consultation expected to take place in Spring 2011, but the wider associated issue of plurality of public service providers is addressed in the latest call for evidence.

The TUC believes that the retention of the Fair Deal protections is essential to prevent a race to the bottom in outsourced public services. There is understandably considerable anxiety among unions about the future of Fair Deal, particularly given the abolition of the Two-Tier Code which provides similar protections on terms and conditions for new employees in contracted out public services. We would therefore urge the Commission to base any recommendations about plurality of provision in the final report on the available evidence and to reflect the need it has identified not to level-down provision. This would be consistent with the principles set out in the Commission's first report.

This objective would be strengthened by greater use of the Public Sector Transfer Club, which would facilitate greater flexibility and mobility among the public service workforce.

The current arrangements, including open admission agreements under which private sector employers are allowed to participate in public service schemes in respect of both transferred employees and new employees, provide a relatively level playing field. If anything, in-house bids are disadvantaged as they factor in providing good quality pensions for subsequent hires, whereas the private sector can factor in a reduction in pension costs as new employees are given worse terms. Reducing the level of protection would have precisely the opposite effect. Bids would be

awarded not on the efficiency of the provider but on cutting future pension rights, with wide-ranging consequences for public services, employees and future welfare costs.

The issue of maintaining decent pension provision in contracted out public services is particularly relevant to the Commission's aim of protecting the low paid. Many services that are characterised by low pay and a predominantly female workforce - such as cleaning and catering - have been widely outsourced.

Mechanisms for admitted body status (ABS) mean it is possible for all contractors and in-house providers to bid for service provision contracts on an equal basis. Unions and many of the leading contractors believe that there is potential to explore further extending ABS in the public service schemes. We understand that the CBI is supportive of measures along these lines, providing there is an appropriate allocation of cost and risk between the private sector employer and the scheme concerned.

Unions believe that concerns about ABS provisions in the LGPS have been overstated. Some of the issues about costs to contractors flow from a lack of awareness of pension issues and a lack of existing provision by contractors for their own staff before taking on a public sector contract. The first of these can be addressed by improving procurement procedures, so that issues around the distribution of costs and risks can be negotiated during the tendering and contracting process. Again, this is consistent with the approach advocated by the CBI in their response to the Commission's first call for evidence.

Finding a positive solution to the problems faced by contractors in providing comparable provision is a goal which would be supported by employees and most contracting employers. This would simplify pensions for both parties, provide a level playing field for contractors and some certainty for the workers affected.

Administration costs (Qus 20-22)

Administration costs are generally much lower in the public service schemes, mainly on account of the natural advantage of their scale, but also as a result of sound management on the part of those responsible. However, experience from the private sector shows that there is still a role for more effective oversight, with administration agreements that spell out performance targets for most aspects of the administration work and close and regularly monitoring of performance. TUC believes that there is some scope for the existing governance bodies for the various public service schemes to develop a greater role in this area.

As an example of what can be achieved, a considerable amount of work has taken place in recent years to improve the administration of the PCSPS, both in terms of the organisation which administers the schemes, as well as encouraging staff to fully understand the value of their pension. This led in April 2010 to the creation of one overall organisation, known as My Civil Service Pension, under the management control of one civil service employer (DWP). A number of smaller administrators have combined to create this new organisation, saving costs as well as improving the administration for staff as well as the pensioner community.

As far as the LGPS is concerned, there is scope for rationalisation, most notably in respect of bringing funds together for the purposes of achieving savings in investment management, through approaches such as a 'common investment fund' model. One estimate developed by Unison has suggested that this would generate £1bn additional annual income for these funds. There is also scope for funds to work together in extending best practice and achieving improved performance while, on administration, the provision of shared service might also realise economies. The aim should be that such steps, up to and including possible fund mergers, should offer the opportunity to create a modern and effective basis for the management of the scheme's assets going forward. The economic benefits of fund mergers should be shared between employers - and therefore the taxpayer - and employees.

The TUC also believes that the LGPS should be subjected to the requirements of European Directive 41/2003 'Institutions for Occupational Retirement Provision'. This requires Articles 8 and 18 to be addressed to the LGPS. Under these articles the LGPS must be legally separated from the sponsoring employers. Investments must be made in the best interests of scheme members and where conflicts of interest arise, they must be resolved in the favour of scheme members. There are other investment obligations, for example, prudential investing, the use of regulated markets and a limited use of derivatives. All of the above requirements are currently absent from the LGPS investment regulations.

Transition issues (Qus 23 to 25)

The TUC believes that the issues that arise from the transition to any new pension structure for public service workers are, at present, poorly understood, while being of crucial importance. Even if the TUC were to agree with the Commission's final recommendations of where public service pensions should be in the best of all possible worlds, it is still possible that the pain and cost of getting there will mean that the trip is simply not worthwhile. Unless and until these potential difficulties are fully understood, the existing system has to be maintained.

In summary, the potential issues that need to be fully explored before implementing any change are as follows:

- The direct cost of the process of change itself has to be quantified, including the very substantial series of communication exercises that would be needed;
- The extent to which the uncertainty and unpopularity of the changes will lead to large numbers of public service workers opting-out of these schemes or, in future, deciding not to join - an outcome made much more likely by the change in the basis for pension increases to the CPI and the arbitrary increase in member contributions; and
- A full understanding of possible technical difficulties that have the potential to increase scheme liabilities as a direct result of a change in structure. For example, members of the NHSPS are entitled to take unreduced benefits from age 60 but, under the current arrangements, many choose not to because they work past that age and remain active members of the Scheme.
- LGPS funding issues, especially the impact on investment strategies that are in operation in the 101 UK local government funds. A sudden change in benefit structure, contribution levels or membership will have a potentially costly and certainly disruptive effect on the sustainability and efficiency of the LGPS

The TUC's underlying concern is that because of the environment in which the review is taking place, the Commission cannot ensure an effective transition to any new arrangements. Members will not have confidence that the new arrangements are fair, suitable and sustainable, because of the experience of the arbitrary and unilateral way in which changes to indexation and contribution rates have been introduced by the Government in the meantime. We would urge the Commission to clearly and strongly recommend that any changes are the result of full consultation and negotiation with the relevant trade unions from an early stage.

A second issue of importance to the transition to any new system is that members need to have confidence that their accrued rights will be fully protected, in line with commitments made by the coalition government. There is a significant danger that this confidence will be undermined by the change in indexation, if the Government confirms that this will apply to past service benefits as many suspect.

Conclusion

The TUC urges the Commission to recommend that the Government should adopt a coherent approach to the future of public service pensions, based the established structures of collective bargaining and, in particular, the cap and share arrangements. The Commission's own work and that of the NAO has demonstrated that this is sustainable in the long-term. It is also clear that the provision of good pensions in the public sector is an essential element of the Government's overall policy for pensions.

Trade unions are not opposed to change in public service pensions but any such change should be based on detailed evidence; it should be scheme specific, drawing on the experience of those involved with each scheme; and it should follow a proper process of negotiation and agreement between the appropriate trade unions and the Government.

Annex 1

JOINT TRADE UNION SUBMISSION TO THE INDEPENDENT PUBLIC SERVICE PENSIONS COMMISSION LOCAL GOVERNMENT PENSION SCHEME

INTRODUCTION

This submission is on behalf of Unison, GMB and Unite in response to Lord Hutton's request for further evidence for the Commission's full report. It is in light of the unique context of the Local Government Pension Scheme which we do not think has been fully recognised that we are making this joint submission.

Collectively we represent 1.2m current, contributing members of the LGPS throughout the UK and many more with deferred pensions or pensions in payment.

Our two major concerns are: firstly that the **specific nature** of the LGPS is not being properly considered and solutions purporting to address issues with unfunded schemes are simply being applied to the funded LGPS without any consideration of the particular impact that will result on the scheme's four million members; and secondly that the announcement in the CSR relating to employee contributions fundamentally threatens the continued existence of the LGPS as a viable and sustainable pension scheme for the local government workforce.

INTERIM REPORT

While we appreciated the Commission's determination to reject the 'race to the bottom' approach to public sector pensions we are concerned that the Commission's view of admission agreements in the context of Fair Deal undermines this principle. The unions maintain that the only way to achieve a level playing field in terms of providing pensions for outsourced services is for open admission agreements to be the standard with pass through of relevant costs agreed between the contractor and authority at the outset.

The interim report stated that the most effective way to make short term savings is to increase members' contributions. This is not the case in the LGPS which, as a funded scheme, is actuarially valued every three years when assumptions of income and expenditure are set for the following three years and reflected in employer contribution rates. Changes to benefits are therefore as able to result in short term savings as employee contribution increases and, we argue, have a much less devastating effect on scheme sustainability.

COMPREHENSIVE SPENDING REVIEW

The Chancellor in the CSR announced what is in effect a 3% increase in employee contributions as part of a policy to save £1.8bn from the Annual Managed Expenditure (which relates to what are generally known as the 'Pay As You Go' schemes). Explicitly included in this policy is the LGPS, despite the fact that as a funded scheme the LGPS does not play a part in Annual Managed Expenditure and no automatic savings would be forthcoming as a result of the LGPS's inclusion. The 3% increase is therefore nothing more than a tax. The cash equivalent of 3% will be deducted from the settlement grant to local authorities so there will be no benefit to the scheme or employers. In fact the localised nature of the scheme means that the grant reduction will not accurately reflect the increased yield from employee contributions as that yield differs from fund to fund.

The unions believe the impact of the 3% increase in employee contributions will have devastating consequences on the sustainability of the LGPS. Our main reasons for this view are as follows:

1. Unlike other parts of the public sector, members covered by the LGPS have not only had their pay frozen but there have been pay cuts. In addition the protection for those earning less than £21,000 does not apply in local government leading to a specific effect on the capacity of LGPS members to increase their contributions to the scheme or to a pension 'levy'.
2. Protecting the lowest paid from the levy means the pressure on moderate earners will be intolerable for many. The membership profile for the LGPS is notably different to that of the other public sector schemes: 68.2% of members earn less than £22,000 a year while 87.3% of members earn less than £30,000 (full time equivalent). Unions estimate that in order to generate the 9.4% yield required by the Chancellor's announcement and protect only the lowest paid – those earning less than £18,900 – contribution rates for those earning more may have to almost double with a member earning £20,000 being required to pay 12%, an annual increase of more than £1,000 while someone on £33,000 would be contributing at a rate of 12.5% an increase of almost £2,000 a year. The limited number of members at the top of the earnings scale means that their contributions will have to increase still further, to 13.4% for someone earning £40,000 (a £2,280 annual increase in contributions) and to 14% for someone earning £100,000 (a £6,500 annual increase).
3. The volume of part time employees in the scheme, approximately 75% of members, will exacerbate the number of members opting out on grounds of affordability. Members' actual earnings can be low but because their contribution band is assessed on the basis of full time equivalent earnings they may well find themselves paying an unaffordable 12% of a low salary. Many of these scheme members, like those on moderate earnings will not be able to sustain membership and will therefore stop saving. Those on higher earnings may well find

- that a combination of high contribution rates and a career average scheme means that they no longer see merit in saving in the LGPS and they will seek other options for their retirement provision.
4. The consequence of increased opt-outs should not be underestimated. Not only will this mean an overall decline in pension saving but it will also make it more difficult to generate the 3% increase in yield targeted, potentially leading to even higher contribution rates as more money is sought from fewer members.
 5. As GAD confirm that the future service cost of the LGPS is falling as was planned in the 2008 reforms (from 19.1% to 18.6% between 2007 and 2010), this increase in employee contributions alone means that employees will be paying more than employers for the current benefit. In addition, the saving from the cut in indexation from RPI to CPI is not included in GAD's assessment of the future service cost. This effect is likely to result in a substantial reduction as indicated by the PPI report in November 2010, however even using the same basis as the Pension Protection Fund, this would reduce the total future service cost of the LGPS to around 17.3% with the employee paying on average 9.4% and the employer ultimately paying 7.9%. This is also not the end of the story as there are further savings due from the reforms already in place.
 6. If the Commission's final report advocates a further reduction in the scheme's value then despite being a defined benefit scheme, the LGPS's effective value to members will fall well below private sector comparators.
 7. The unions believe to be sustainable the LGPS must be affordable for **both** employees and taxpayers. If savings must be made, and the case for savings in the LGPS has not been made, then there are more appropriate means of achieving the goal that do not undermine the scheme's viability. Benefit changes could occur in the LGPS leading to savings ahead of the supposed yield from the phased introduction of the contribution increase from April 2012. As we showed in the creation of the 2008 scheme, unions and employers can develop a package of reforms that balance contribution changes and benefits.

We urge the Commission to recognise the particular impact the CSR announcement will have on the LGPS, to reflect this in its final report and recommend that any savings are made through a combination of member contribution adjustments and benefit changes *not* purely added to the employee contribution yield.

FURTHER REFORM

The CSR announcement is a major barrier to longer term reform of the LGPS. Previously, the unions were prepared to enter into discussions on future reforms to the LGPS, this now significantly more difficult. With an average contribution of 9.4%, the LGPS will no

longer be an affordable scheme for many who would otherwise be saving for retirement. In this context the future design of the scheme will be different as large sections of the workforce will be excluded.

Nevertheless, we are supportive of the consideration of a move to a career average model of defined benefit provision going forward providing this is a scheme of no less overall value than the current LGPS. However, for the reasons outlined above, any move towards a career average scheme is severely hampered by the impact of the member contribution levy and, as outlined in previous union submissions, the experience of unilateral change in the revaluation mechanism in *nuvos*.

We do not believe a hybrid option is appropriate for the LGPS. As demonstrated above, relatively few members earn more than a moderate salary and the administration and complexity a part defined benefit - part defined contribution arrangement would necessitate does not seem of benefit to the taxpayer anymore than it would for the members. A hybrid option would be the worst of both worlds.

The unions are keen to explore potential savings from shared services or fund mergers in relation to administration and investment management costs. We do not believe this is a simple exercise as performance varies widely between funds in both these areas and a blunt decision without due investigation could actually generate more cost. We would highlight however, that for the most part the LGPS is very efficiently administered with average administration costs for example of £18.88 per member compared with £47 per member for in-house private sector administration costs and a cost of £41 per member for outsourced private sector administration.

CONCLUSION

The LGPS trade unions have worked hard with funds, actuaries, employers and others over the last few years to make the scheme sustainable and relevant to employers and employees. We urge the Commission to pay specific attention to the **specific nature** of the scheme, the biggest in the public sector with more than £150bn in assets and a membership of more than four million. It is a scheme that accounts for around 5% of the average taxpayer's council tax yet provides on average a little over £4,500 (£2,870 for women) for the pensions of dinner ladies, classroom assistants, carers, social workers and many other professionals providing front line services to the most vulnerable people in society.

The LGPS is one of the few public sector schemes that are funded and therefore requires specific consideration. Reform is possible but it must be appropriate and when a scheme is run well this should be recognised.